No. 87-1284

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

TRANS WORLD AIRLINES, INC.;
TRANSWORLD CORPORATION,

Petitioners,

—v.—

JOEL KRONFELD,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SUPPLEMENTAL BRIEF IN SUPPORT OF THE PETITION

Of Counsel:

NORMAN C. KLEINBERG
VILIA B. HAYES
HUGHES HUBBARD & REED

ROBERT J. SISK*
One Wall Street
New York, New York 10005
(212) 709-7000
Attorney for Petitioner Transworld Corporation

Of Counsel:

IRWIN H. WARREN
DUSHICA D. BABICH
WEIL, GOTSHAL & MANGES

DENNIS J. BLOCK*
767 Fifth Avenue
New York, New York 10153
(212) 310-8000
Attorney for Petitioner Trans World Airlines, Inc.

* *Counsel of Record*

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SUPPLEMENTAL BRIEF

Petitioners Trans World Airlines, Inc. ("TWA") and Transworld Corporation ("TWC") file this Supplemental Brief pursuant to Rule 22.6 of the Rules of this Court in light of the Court's recent decision in *Basic Inc. v. Levinson*, No. 86-279, slip op. (U.S. March 7, 1988), which was handed down after petitioners filed their petition for writ of certiorari and before respondent filed his opposition.

Contrary to respondent's contention, *Basic Inc. v. Levinson* did not lay to rest the legal issues raised by this Petition. *Basic* considered only the "narrow" issue (slip op. at 10) of materiality in the context of merger negotiations—events which had gone beyond a merely internal exploratory stage and which instead had been considered and authorized for action by those responsible for decision-making at the "highest corporate levels" (slip op. at 14), and involving negotiations which already had commenced. This Court explicitly stated in *Basic* that it did "not address here any other kinds of contingent or speculative information." *Id.* at 7 n.9.

This Petition presents a complementary, undecided and far wider-reaching issue at the opposite end of the spectrum—whether *Basic* foreclosed summary judgment on the issue of the materiality of a contingent or future event when none of the "indicia of interest" at the highest levels of the corporation, described in *Basic*, are present and the court finds the event was, at the time of disclosure, merely a "possibility," not a probability.

Unlike *Basic*, where the alleged nondisclosure concerned ongoing merger negotiations authorized and participated in by the Board of Directors, this case involves an alleged failure to disclose the existence of an unfinished study by a consultant of numerous corporate options or the possibility that one of those options might be the subject of future corporate action—prior to any consideration of, much less action upon or adoption of, either the study or any of the possible options by the issuer's decision-makers. Thus, the Petition presents this Court with an

opportunity to clarify that the case-by-case analysis proposed by *Basic* does not preclude summary judgment when there is no evidence to support the "probability" portion of the probability/magnitude test set forth in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969), and adopted by this Court in *Basic*. Slip op. at 13-16.

Furthermore, *Basic* confirmed petitioners' assertion that the opinion below in this case was fundamentally in error. The application below by a divided panel of the Second Circuit of the probability/magnitude balancing test (3a),[1] as set forth in *Texas Gulf Sulphur*, is wholly inconsistent with this Court's interpretation of that test in *Basic*. Slip op. at 13-16.

I.

THE PETITION PRESENTS AN ISSUE COMPLEMENTARY TO, AND UNRESOLVED BY, *BASIC* WHICH SHOULD BE RESOLVED BY THIS COURT.

In *Basic*, this Court declined to apply a "bright-line" test of immateriality to merger negotiations in the context in which the Board had considered the possibility of a merger, had authorized management to enter into such negotiations and was itself participating in the negotiations which were underway. Instead, this Court held only that the "narrow" question faced—whether the "existence and status of preliminary merger discussions" (slip op. at 10) is significant to the reasonable investor's trading decision—should be judged under the *Texas Gulf Sulphur* test of balancing the "indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." Slip op. at 13 (citing *Texas Gulf Sulphur*, 401 F.2d at 849).

This Court left unresolved the issue presented here: Under the *Texas Gulf Sulphur* balancing test, at how early a stage

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1 References herein to "_____ a" are pages of the Appendix contained in the Petition.

must a contingent or speculative event be in the corporate evaluative and decision-making process before it can be deemed immaterial as a matter of law?

The decision below by the Second Circuit majority destroys the utility of summary judgment on the issue of the materiality of a contingent event; for it interprets the *Texas Gulf Sulphur* test to mean that a jury question is created whenever a contingent event is one of magnitude, so long as that future event is at least a "possibility." While *Basic* held that preliminary merger discussions could be material depending on all the facts and circumstances, this Court did not rule out that some events could be so contingent that they were immaterial as a matter of law. Though recognizing that a merger is often of great significance to a company, this Court in *Basic* remanded the case for reconsideration, including a determination of the probability at the time of non-disclosure that the merger would occur and suggested that probability should be examined in light of the "indicia of interest in the transaction at the highest corporate levels" (slip op. at 14):

> Without attempting to catalog all such possible factors, we note by the way of example that board resolutions, instructions to investment bankers and actual negotiations between principals or their intermediaries may serve as indicia of interest. *Id.*

In the present case, by July 29, 1983 (the date of the prospectus at issue), there was *no* "Board resolution" regarding a TWA spinoff; there was *no* "instruction to the investment bankers" by the Board or even top management to take any steps regarding a spinoff, as opposed to merely evaluating a number of corporate options; there still had been *no* consideration of a spinoff by the Board or presentation of such option to the Board; and there was *no* consensus among the Board or even management regarding the wisdom of a spinoff. As of July 29, 1983, all that existed was an unfinished study by Gold-

man Sachs, still in progress, which was evaluating a number of corporate alternatives.[2]

Under the balancing test as adopted and interpreted in *Basic*, such contingent "possibilities" of alternatives which are at a wholly exploratory stage and which have not yet been presented to corporate decision-makers should be held to be immaterial as a matter of law. To hold otherwise would mean that every time an issuer is merely studying any one or more potentially significant corporate alternatives, a jury question is presented as to whether the issuer should have disclosed such alternatives—even if they had not yet been finalized, or presented for consideration or approval by the Board and, indeed, even if there was no Board or management consensus that any one or more of such alternatives should be adopted—so long as ultimate adoption of any one of such alternatives could not be conclusively ruled out.

The adverse implications of any such rule are obvious. Issuers properly are continually engaged in studying a wide range of subjects of possible future corporate action—often significant action. Studies by consultants and staff regarding significant possible alternatives which might affect a corporation, such as studies of alternative acquisition or merger candidates, other corporate investments, financing plans, financial restructurings, studies of new products or exploration for new sources of raw materials, all would have to be disclosed even though they were at a wholly exploratory stage and had not been completed, much less considered, by the Board.

This Court should grant the petition to clarify that this disclosure standard simply is not the "law of the land" after *Basic* as respondent contends.

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2 Although respondent repeatedly refers to a "plan" by top management to spin off TWA, the record clearly demonstrates that there was no consensus among even management, let alone the Board, as to the desirability of a spinoff. When the study was finally completed and presented to the Board in September, the Board did not immediately adopt it. Rather, the matter was referred to the Finance Committee of the Board for review and recommendation.

II.

THE SECOND CIRCUIT'S DECISION IS INCONSISTENT WITH *BASIC*.

In applying the probability/magnitude test, a divided panel of the court of appeals concluded that the significance of a spinoff would be great. However, on the issue of probability, the court stated:

> The likelihood of the event's occurrence cuts much less sharply in favor of plaintiff [respondent], but there was certainly, at a minimum, a substantial possibility of its occurrence. (33a).

The court thereby implicitly acknowledged that there was no basis (other than hindsight) for believing a spinoff was probable when the prospectus was issued. Indeed, in its original opinion reversing summary judgment, the Second Circuit majority assessed the "possibility" of a TWA spinoff as merely being "not wholly remote" (24a); then, without any further review or explanation of the facts, by amendment of its opinion on motion for rehearing, it termed the spinoff a "substantial possibility." (33a).

The court of appeals' "substantial possibility" standard cannot be squared with *Basic*, which requires a balancing of the "probability" that the event will occur (slip op. at 15), and not a mere possibility, and sets forth that probability should be analyzed, *inter alia*, in terms of interest in the transaction "at the highest corporate levels" (giving board resolutions as an example of indicia of such interest).

Respondent attempts to reconcile the court of appeals' analysis with *Basic* by arguing that where the magnitude of the contingent event would be extremely great, *Basic* requires only a "possibility," not a probability. Respondent's Opposition Brief at 11-12, 17-19.

First, nowhere did this Court indicate that the probability/magnitude test should be replaced with a possibility/magnitude

test. This interpretation would be inappropriate especially where, as here, the possibility was, as Judge Weinfeld of the district court found, "long in advance of the first consideration of the question by those responsible for decision." (45a). The absurdity of respondent's analysis of *Basic* is most clear when applied in the context of mergers: If the probability standard is replaced with a mere possibility standard, issuers would have to disclose the fact that corporate staff or advisers were merely studying potential acquisition or merger candidates, even before the company's Board of Directors had considered the wisdom of a merger generally, much less with anyone in particular.

Respondent's reliance on the case law citation in footnote 19 of *Basic* is equally misplaced. Each of those cases involved at least a "board resolution" authorizing management to enter into merger negotiations and/or "actual negotiations between principals or their intermediaries"—the very indicia of interest at the "highest corporate levels" to be considered in assessing the probability that the event will occur which are not present here.[3]

Second, no matter which label is employed—"possibility" or "probability"—the court of appeals did not have the benefit of this Court's guidance in *Basic* and did not consider the existence or extent of the indicia of interest at the "highest corporate levels" of a TWA spinoff. Had it considered these indicia, it

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3 *See, e.g., SEC v. Gasper*, [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004 at 90,977-80 (S.D.N.Y. April 15, 1985) (merger talks had proceeded "substantially beyond the exploratory stage" to establishment of pre-conditions and the existence of price proposals); *Dungan v. Colt Industries, Inc.*, 532 F. Supp. 832, 836 (N.D. Ill. 1982) (sale of company was being "discussed within the company and . . . with potential purchasers"); *SEC v. Shapiro*, 494 F.2d 1301, 1306 (2d Cir. 1974) (insiders trading on information with knowledge that merger "negotiations [between the parties had] recommenced"); *Holmes v. Bateson*, 583 F.2d 542, 546-51 (1st Cir. 1978) (actual negotiations between principals taking place); *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 746 (E.D. Va. 1980) (court explicitly found that misrepresentation that merger negotiations were "preliminary and exploratory" was false and that merger negotiations were "serious and substantive").

could have come to no other conclusion but that the information was immaterial as a matter of law because one half of the balancing test—"probability"—was missing. The record demonstrates that there simply was no Board consideration of, much less any Board resolution approving, a TWA spinoff by July 29.

In light of the recent clarification of the materiality standard in *Basic*, the plain error in the decision below should be reversed.

CONCLUSION

The petition for writ of certiorari should be granted.

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New York, New York

Respectfully submitted,

Of Counsel:

NORMAN C. KLEINBERG
VILIA B. HAYES
HUGHES HUBBARD & REED

ROBERT J. SISK*
One Wall Street
New York, New York 10005
(212) 709-7000
Attorney for Petitioner
Transworld Corporation

Of Counsel:

IRWIN H. WARREN
DUSHICA D. BABICH
WEIL, GOTSHAL & MANGES

DENNIS J. BLOCK*
767 Fifth Avenue
New York, New York 10153
(212) 310-8000
Attorney for Petitioner
Trans World Airlines, Inc.

* *Counsel of Record*